

ORIGINAL

COMMISSIONERS
MIKE GLEASON - Chairman
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KRISTIN K. MAYES
GARY PIERCE

OPEN MEETING ITEM



0000090894

BRIAN C. McNEIL
Executive Director
RECEIVED

ARIZONA CORPORATION COMMISSION

DEC -4 A 10:07

DATE: DECEMBER 4, 2008

DOCKET NOS: T-01847A-07-0392, T-02727A-07-0392, T-04169A-07-0392, and
T-02739A-07-0392

TO ALL PARTIES:

Enclosed please find the recommendation of Administrative Law Judge Sarah N. Harpring. The recommendation has been filed in the form of an Opinion and Order on:

VALLEY TELEPHONE COOPERATIVE, INC., COPPER
VALLEY TELEPHONE, INC., VALLEY CONNECTIONS, LLC, and VALLEY
TELECOMMUNICATIONS COMPANY, INC.
(REORGANIZATION)

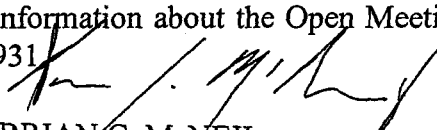
Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and thirteen (13) copies of the exceptions with the Commission's Docket Control at the address listed below by 4:00 p.m. on or before:

DECEMBER 11, 2008

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Open Meeting to be held on:

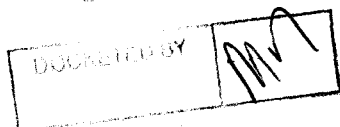
TO BE DETERMINED

For more information, you may contact Docket Control at (602) 542-3477 or the Hearing Division at (602) 542-4250. For information about the Open Meeting, contact the Executive Director's Office at (602) 542-3931.


BRIAN C. McNEIL
EXECUTIVE DIRECTOR

Arizona Corporation Commission
DOCKETED

DEC -4 2008



1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 **COMMISSIONERS**

3 MIKE GLEASON, Chairman
4 WILLIAM A. MUNDELL
5 JEFF HATCH-MILLER
6 KRISTIN K. MAYES
7 GARY PIERCE

8 IN THE MATTER OF THE REORGANIZATION
9 OF VALLEY TELEPHONE COOPERATIVE, INC.,
10 COPPER VALLEY TELEPHONE, INC., VALLEY
11 CONNECTIONS, LLC, AND VALLEY
12 TELECOMMUNICATIONS COMPANY, INC.

DOCKET NO. T-01847A-07-0392
DOCKET NO. T-02727A-07-0392
DOCKET NO. T-04169A-07-0392
DOCKET NO. T-02739A-07-0392

DECISION NO. _____

13 **OPINION AND ORDER**

14 DATE OF HEARING: September 10, 2008

15 PLACE OF HEARING: Phoenix, Arizona

16 ADMINISTRATIVE LAW JUDGE: Sarah N. Harpring

17 IN ATTENDANCE: Chairman Mike Gleason

18 APPEARANCES: Mr. Jeffrey W. Crockett, and Ms. Marcie A. Shuman,
19 Snell & Wilmer, LLP, on behalf of Valley Telephone
20 Cooperative, Inc. et al.; and

Mr. Kevin O. Torrey, Staff Attorney, Legal Division, on
behalf of the Utilities Division of the Arizona
Corporation Commission.

21 **BY THE COMMISSION:**

22 On June 28, 2007, Valley Telephone Cooperative, Inc. ("Cooperative"); Copper Valley
23 Telephone, Inc. ("Copper Valley"); Valley Connections, LLC ("Valley Connections"); and Valley
24 Telecommunications Company, Inc. ("VTC") filed with the Arizona Corporation Commission
25 ("Commission") a notice of intent to (1) organize a public utility holding company and (2) reorganize
26 the ownership interest of Valley Connections ("application"). In the application, Cooperative
27 proposed to organize VTG Holdings, Inc. ("VTG Holdings") as a holding company to take ownership
28 of Copper Valley, Valley Connections, and VTC ("the affiliates"). The application revealed that
Copper Valley had transferred its membership interest in Valley Connections to Cooperative in

1 September 2006, making Cooperative the direct owner of all of Valley Connections. Cooperative
2 and Copper Valley believed that this transfer did not require Commission approval, as there was no
3 change of control. However, in the application, Cooperative and Copper Valley also requested that
4 the Commission approve the transfer, if the Commission determines that Commission approval is
5 required.

6 On October 4, 2007, the Commission's Utilities Division Staff ("Staff") issued a
7 Memorandum and Recommended Order recommending that the application be approved without a
8 hearing pursuant to Arizona Administrative Code ("A.A.C.") R14-2-803 because Staff believed that
9 the transaction proposed did not (1) impair the financial status of Cooperative and the affiliates; (2)
10 prevent Cooperative and the affiliates from being able to attract capital at fair and reasonable terms;
11 (3) prevent Cooperative and the affiliates from being able to provide safe, reasonable, and adequate
12 service; or (4) adversely affect customers.

13 On October 22, 2007, Chairman Gleason docketed Proposed Amendment #2 to the
14 Recommended Order, which raised questions concerning the value of the shares transferred among
15 regulated and non-regulated entities and whether allocation of tax liability or credits among the
16 affiliates would require Commission approval. The proposed amendment would have directed the
17 Hearing Division to conduct a hearing to address those questions and any related questions that arose
18 during the hearing.

19 The Recommended Order and Chairman Gleason's Proposed Amendment #2 were discussed
20 by the Commission at its Open Meeting on October 24, 2007. Chairman Gleason's Proposed
21 Amendment #2 did not pass, on a vote of 2-2. The Recommended Order itself also did not pass, on a
22 vote of 2-2.

23 On March 11, 2008, Cooperative and the affiliated companies filed a letter requesting that the
24 Memorandum and Recommended Order be scheduled for consideration at the next open meeting. As
25 a result, the Memorandum and Recommended Order were scheduled for consideration at the Open
26 Meeting on April 8 and 9, 2008.

27 On April 1, 2008, Chairman Gleason docketed Proposed Amendment #1, which included the
28 same language as the prior amendment considered in October 2007.

1 At the April 2008 Open Meeting, both Chairman Gleason's Proposed Amendment #1 and the
2 Recommended Order, as amended, passed, resulting in Decision No. 70307 (April 24, 2008).
3 Decision No. 70307 ordered the Commission's Hearing Division to conduct a hearing on the
4 application pursuant to A.A.C. R14-2-803 to address the issues identified in Findings of Fact Nos. 23
5 and 24 of Decision No. 70307.

6 On April 29, 2008, a Procedural Order was issued scheduling the hearing in this matter for
7 July 22, 2008, at 9:30 a.m.; requiring Cooperative and the affiliates to file written testimony and any
8 related exhibits by May 27, 2008; and requiring Staff to file written testimony and any related
9 exhibits by June 25, 2008.

10 On May 22, 2008, in response to a Motion to Extend Testimony Deadline filed by
11 Cooperative and the affiliates on May 21, 2008, a Procedural Order was issued extending
12 Cooperative and the affiliates' deadline for filing written testimony and any related exhibits to June 3,
13 2008, and extending Staff's deadline for filing written testimony and any related exhibits to July 2,
14 2008. The Procedural Order did not change the hearing date of July 22, 2008.

15 On June 4, 2008, in response to a second Motion to Extend Testimony Deadline filed by
16 Cooperative and the affiliates on June 3, 2008, a Procedural Order was issued extending Cooperative
17 and the affiliates' deadline for filing written testimony and any related exhibits to June 10, 2008, and
18 extending Staff's deadline for filing written testimony and any related exhibits to July 9, 2008. The
19 Procedural Order also vacated the hearing scheduled for July 22, 2008, and scheduled a hearing for
20 August 14, 2008, at 9:00 a.m.

21 On June 6, 2008, so as to avoid a conflict with the Securities Open Meeting scheduled for
22 August 14, 2008, another Procedural Order was issued vacating the hearing scheduled for August 14,
23 2008, and scheduling a hearing for August 21, 2008. The Procedural Order also required
24 Cooperative and the affiliates to publish notice of the application and hearing by July 7, 2008, and to
25 file Affidavits of Publication by July 28, 2008, and established other procedural deadlines.

26 On June 10, 2008, Cooperative and the affiliates filed the Direct Testimony of Steven D.
27 Metts and William M. Miller.

28 On July 3, 2008, Staff filed a Motion to Extend Time to File Staff Report and to Reset

1 Hearing Date, in which Staff requested that the procedural schedule be amended to allow Staff
2 approximately three additional weeks to prepare accounting analyses and testimony. Staff also
3 requested that the August 21, 2008, hearing date be vacated and rescheduled to a date no earlier than
4 August 28, 2008.

5 On July 7, 2008, Cooperative and the affiliates filed a Response to Staff's Motion to Extend
6 Time to File Report and to Reset Hearing Date, stating that although Cooperative and the affiliates
7 did not object to Staff's Motion, they requested a new hearing schedule that would allow for the
8 Commission to issue a Decision before the end of 2008.

9 On July 8, 2008, at the request of the Hearing Division, a telephonic procedural conference
10 was held in this matter. The parties appeared through counsel. During the procedural conference,
11 Cooperative and the affiliates stated that publication of notice had been made as required by the
12 Procedural Order issued on June 6, 2008. In light of this, it was announced that the hearing
13 scheduled for August 21, 2008, must proceed for the taking of public comment. Also, it was agreed
14 that the hearing would be rescheduled to September 10, 2008, at 9:30 a.m., and other procedural
15 deadlines were discussed. Counsel for Cooperative and the affiliates requested not to be required to
16 republish notice, and that issue was taken under advisement for resolution in a Procedural Order.

17 On July 9, 2008, a Procedural Order was issued providing that the hearing scheduled for
18 August 21, 2008, would proceed only for the taking of public comment; scheduling a hearing for
19 September 10, 2008; requiring Staff to file written testimony and related exhibits by July 28, 2008;
20 requiring Cooperative and the affiliates to file Affidavits of Publication by July 28, 2008, for the
21 notice that had already been published; and requiring the filing of any disagreements/comments
22 regarding the application or written testimony by August 29, 2008.

23 On July 24, 2008, Cooperative and the affiliates filed Notice of Filing Affidavits of
24 Publication showing that notice of the application and the August 21, 2008, hearing date had been
25 published in the *Eastern Arizona Courier*, the *San Pedro Valley News-Sun Arizona Range News*, and
26 *The Copper Era* on July 2, 2008.

27 On July 28, 2008, Staff filed the Direct Testimony of Darron W. Carlson.

28 On August 21, 2008, the hearing was convened solely for the taking of public comment.

Cooperative and the affiliates and Staff appeared through counsel. During the proceeding, the new hearing date was announced on the record. No members of the public attended to provide comment.

On September 10, 2008, the hearing reconvened as scheduled. Cooperative and the affiliates and Staff appeared through counsel and presented evidence and testimony.

On December 2, 2008, Cooperative and the affiliates filed a letter stating that they waive the 10-day exception period in this matter. Cooperative and the affiliates have requested that the Commission issue an order approving the reorganization before the end of 2008. (Tr. at 88.)¹

* * * * *

Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

FINDINGS OF FACT

1. On June 28, 2007, Cooperative and the affiliates filed with the Commission a notice of intent to (1) organize a public utility holding company and (2) reorganize the ownership interest of Valley Connections. In the application, Cooperative proposed to organize VTG Holdings as a holding company to take ownership of the affiliates. The application also revealed that Copper Valley had transferred its membership interest in Valley Connections to Cooperative in September 2006, making Cooperative "the direct owner of all of the stock of Valley Connections." (Ex. A-1 at 2.) Cooperative and Copper Valley believed that this transfer did not require Commission approval, as there was no change of control. However, in the application, Cooperative and Copper Valley also requested approval of the transfer, if the Commission determines that Commission approval is required.

2. Cooperative and the affiliates specifically propose to reorganize by (1) having Copper Valley cancel all 100 shares of common stock held by Cooperative and reissue 100 shares of common stock to VTG Holdings; (2) having VTC cancel all 100 shares of common stock held by Cooperative and reissue 100 shares of common stock to VTG Holdings; (3) having Cooperative

¹ Approval of the reorganization after January 1, 2009, could result in two sets of tax returns. (Tr. at 88.) If Cooperative were tax exempt for 2009 because it passed the member income test, the affiliates would file short period returns as stand-alone entities, and then there could be a consolidated return with VTG Holdings from the approval date through the end of the year. (Tr. at 88-89.)

1 execute an "Assignment of LLC Membership Interest" that will assign Cooperative's membership
2 interest in Valley Connections to VTG Holdings; and (4) having VTG Holdings issue 1,000 shares of
3 stock to Cooperative. (Ex. A-1 at 3.)

4 3. On October 4, 2007, Staff issued a Memorandum and Recommended Order
5 recommending that the application be approved without a hearing pursuant to A.A.C. R14-2-803
6 because Staff believes that the transaction proposed does not (1) impair the financial status of
7 Cooperative and the affiliates; (2) prevent Cooperative and the affiliates from being able to attract
8 capital at fair and reasonable terms; (3) prevent Cooperative and the affiliates from being able to
9 provide safe, reasonable, and adequate service; or (4) adversely affect customers.

10 4. Staff's Recommended Order did not pass at the Open Meeting of October 24, 2007,
11 but passed, as amended, at the April 2008 Open Meeting, resulting in Commission Decision No.
12 70307 (April 24, 2008).

13 5. Decision No. 70307 ordered the Commission's Hearing Division to conduct a hearing
14 on the application pursuant to A.A.C. R14-2-803 to address the issues identified in Findings of Fact
15 Nos. 23 and 24 of the Decision, which state the following:

16 23. If the Commission were to approve the proposed
17 reorganization as described in Staff's Memorandum dated October 4,
18 2007, it appears that VTG Holdings would acquire all shares of the
19 Affiliated Companies, while Cooperative would acquire all shares of VTG
20 Holdings. However, the record in this matter does not address the value of
21 the shares after they have been transferred among the regulated and non-
22 regulated entities.

23 24. Staff's Memorandum also indicates that, if the Commission
24 were to approve the proposed reorganization, the companies would
25 allocate income tax liabilities or credits based on their respective
26 contributions of net income or net loss to the consolidated net income or
27 net loss shown on the holding company's consolidated income tax return.
28 However, the record in this matter is silent on the possibility that the
allocation of tax liabilities or credits among separate affiliates would
require Commission approval.

24 6. The hearing in this matter was ultimately scheduled for September 10, 2008, pursuant
25 to a Procedural Order issued on July 9, 2008, which also provided that an August 21, 2008, hearing
26 date would be used solely for the taking of public comment.

27 7. Notice of the application and the August 21, 2008, hearing date were published in the
28 *Eastern Arizona Courier*, the *San Pedro Valley News-Sun Arizona Range News*, and *The Copper Era*

1 on July 2, 2008.

2 8. On August 21, 2008, the hearing was convened solely for the taking of public
3 comment. Cooperative and the affiliates and Staff appeared through counsel. During the proceeding,
4 the September 10, 2008, hearing date was announced on the record. No members of the public
5 attended to provide comment.

6 9. On September 10, 2008, the hearing reconvened as scheduled. Cooperative and the
7 affiliates and Staff appeared through counsel and presented evidence and testimony. Testimony for
8 Cooperative and the affiliates was received from Steven D. Metts, Chief Executive Officer and
9 General Manager for Cooperative and the affiliates, and William M. Miller,² Certified Public
10 Accountant and Tax Partner with the certified public accounting firm of Bolinger, Segars, Gilbert &
11 Moss in Lubbock, Texas. Testimony for Staff was received from Armando Fimbres, Public Utilities
12 Analyst, and Darron W. Carlson, Public Utilities Analyst Manager.

13 10. Cooperative, a non-profit Arizona corporation formed as a cooperative in 1962, is
14 owned by the customers that it serves, who number approximately 3,200. (Ex. A-4; Tr. at 14-15, 33.)
15 Cooperative is an Incumbent Local Exchange Carrier ("ILEC") providing services in rural exchanges
16 in Arizona and in three exchanges in New Mexico. (Tr. at 15.) Cooperative was granted a Certificate
17 of Convenience and Necessity ("CC&N") to provide telecommunications services as an ILEC on
18 August 13, 1962. Cooperative is the sole owner of Copper Valley and VTC, (Tr. at 15-17), and its
19 organization chart shows that Cooperative is also the sole owner of Valley Connections, (Ex. A-4).³

20 11. Copper Valley, a for-profit Arizona corporation, is an ILEC that was formed as a
21 result of Cooperative's buying exchanges from U.S. West in the 1990s. (Tr. at 16; Ex. A-4; Decision
22 No. 70307 at 2.) Copper Valley was granted a CC&N to provide telecommunications services as an
23 ILEC in Decision No. 58763 (September 1, 1994). Copper Valley's Board of Directors is the same
24 as Cooperative's Board of Directors. (Ex. A-4.)

25 12. Valley Connections is an Arizona limited liability company that offers Internet
26 service, television service, and some Competitive Local Exchange Carrier ("CLEC") telephone

27 ² Mr. Miller has been preparing tax returns for Cooperative and its affiliates since 1997. (Tr. at 47-50.)

28 ³ The organization chart shows this because of the September 2006 transaction through which Copper Valley transferred its ownership in Valley Connections to Cooperative.

1 services in the communities of Willcox and Safford. (Tr. at 17.) Valley Connections was granted a
2 CC&N to provide facilities-based competitive local exchange telecommunications services in
3 Decision No. 66846 (March 12, 2004). According to Cooperative's organization chart, Cooperative
4 is the sole member of and manages Valley Connections. (Ex. A-4; Tr. at 17.)

5 13. VTC, a for-profit Arizona corporation, was formed to handle deregulated services,
6 primarily to provide cellular service in the area served by Cooperative. (Ex. A-4; Tr. at 15.) VTC
7 was issued a CC&N to provide cellular service in Decision No. 58670 (June 22, 1994). In 2005,
8 VTC sold its cellular operation, and today its operations essentially consist of a fiber route from
9 Tucson to El Paso, which it holds for resale, and a partnership in a cellular rural service area in New
10 Mexico. (Tr. at 15-16.) VTC is not currently engaged in any operations or services that are regulated
11 by the Commission. (Tr. at 31, 33.) VTC's Board of Directors is the same as Cooperative's Board of
12 Directors. (Ex. A-4.)

13 14. At the time of the hearing, Cooperative also owned Valley Television Services
14 Cooperative, Inc. ("VTV"), a non-profit Arizona corporation that was formed to offer television
15 services. (Tr. at 16.) Mr. Metts testified at the hearing that Cooperative had decided to allow VTV to
16 be administratively dissolved and that the administrative dissolution was expected to be completed
17 within 60 days.⁴ (*Id.*)

18 15. Cooperative also owns Valley Telephone Cooperative Foundation ("Cooperative
19 Foundation"), a non-profit Arizona corporation served by Cooperative's Board of Directors. (Ex. A-
20 4.) Cooperative Foundation is an educational foundation that has as its sole purpose the provision of
21 scholarships to local children using funds from equity checks sent to Cooperative members and
22 returned because the members cannot be located. (Tr. at 16-17.) Cooperative does not intend to have
23 its interest in Cooperative Foundation transferred to VTG Holdings. (Ex. A-5.)

24 16. VTG Holdings was formed in January 2005 as an Arizona for-profit corporation. (Ex.
25 A-1 at 1.) VTG Holdings will be wholly owned by Cooperative, once it is capitalized. (Ex. A-2 at
26 4.) VTG Holdings' Board of Directors is the same as Cooperative's Board of Directors. (Ex. A-5.)

27 _____
28 ⁴ Administrative notice is taken that Commission Corporations Division records show VTV was administratively dissolved effective October 22, 2008.

1 The primary reason Cooperative formed VTG Holdings is to allow for the affiliates to file a
2 consolidated tax return regardless of the results of the "member income test." (Tr. at 22-23.)

3 17. The member income test allows Cooperative, as a non-profit, to file its federal and
4 state income tax returns as a tax-exempt entity in those years in which Cooperative has obtained at
5 least 85 percent of its revenue and income from its members. (Tr. at 59.) The member income test
6 must be met each year to maintain tax-exempt status. (Tr. at 62.) In the past, the affiliates could only
7 file a consolidated tax return with Cooperative for those years in which Cooperative did not meet the
8 member income test and thus was forced to file as a taxable entity. (Tr. at 76.) Cooperative operated
9 as a tax-exempt corporation through the end of 1990 and from 1997 through 2004, but was taxable
10 from 1991 through 1996 and from 2005 through 2007. (Ex. A-3 at 6.) Cooperative's failing the
11 member income test in most of those years was unplanned and due to events beyond Cooperative's
12 control. (*Id.*)

13 18. When Cooperative meets the member income test, it is prohibited from filing a
14 consolidated income tax return with the affiliates because they are for-profit companies. (Tr. at 77;
15 Ex. A-3 at 7 (citing Internal Revenue Code ("I.R.C.") § 1504(b)(1) and A.R.S. § 43-947); *see also*
16 I.R.C. § 1504(e) (allowing two or more tax-exempt organizations to file a consolidated return under
17 certain circumstances).) In the absence of a parent company/holding company that can file a
18 consolidated tax return with the affiliates, each affiliate is required to file a separate stand-alone tax
19 return. (Ex. A-3 at 7.)

20 19. Cooperative believes that the reorganization will streamline and simplify the filing of
21 tax returns for the affiliates, will enhance the affiliates' ability to plan for the future, and will stabilize
22 capital planning because of greater assurance that operating losses will be used to offset earnings in
23 the consolidated income tax returns. Cooperative also believes that the reorganization will preserve
24 and enhance Cooperative's membership equity while assuring the continuation of communications
25 services to all customers of Cooperative and the affiliates. Cooperative believes that filing
26 consolidated tax returns will save money on taxes and thus benefit Cooperative's members, who must
27 pay the taxes. (*See* Tr. at 23.) Mr. Metts testified that if Cooperative can realize a tax savings, it can
28 invest more into infrastructure in the rural areas that it serves. (*Id.*) Cooperative believes that the

1 reorganization is in the public interest because the money will be better used through capital
2 investments than if it were to go to the Internal Revenue Service. (Tr. at 24.) Mr. Metts also testified
3 that the reorganization will not result in any changes in the way Cooperative and the affiliates
4 operate, from a customer perspective. (Tr. at 26.) Cooperative and the affiliates now have
5 centralized billing under the brand name "Valley Telecom Group," and that will not change; there
6 will not be any change in rates; and Cooperative's Board of Directors will not change. (Tr. at 26-27.)

7 20. Cooperative intends to capitalize VTG Holdings by essentially transferring
8 Cooperative's ownership interests in the affiliates to VTG Holdings in exchange for 100 percent of
9 the VTG Holdings stock. (Ex. A-2 at 4.) Mr. Metts testified that the transfer qualifies under I.R.C. §
10 351 and does not result in the recognition of gain or loss to either Cooperative or VTG Holdings
11 because only Cooperative's ownership interests will be transferred, not the cash or assets of the
12 affiliates, which will remain in the affiliates. (*Id.*) The capital structure of Cooperative and the
13 affiliates will be unchanged after the reorganization. (*Id.*)

14 FOF 23—Value of the Shares Transferred

15 21. Findings of Fact No. 23 in Decision No. 70307 stated that it appeared VTG Holdings
16 would acquire all shares of the affiliates, while Cooperative would acquire all shares of VTG
17 Holdings, but that the record did not address the value of the shares after they were transferred among
18 the regulated and non-regulated entities.

19 22. Cooperative's investments in the affiliates are currently recorded on Cooperative's
20 books at net book value. (Ex. A-3 at 4.) Cooperative's books reflect a separate general ledger
21 account for each investment in an affiliate, the balance of which agrees with the net equity of each
22 affiliate. (Ex. A-3 at 4; Tr. at 54.) When the ownership interests are transferred to VTG Holdings in
23 exchange for VTG Holdings stock, the ownership interests will be transferred at the net book value
24 for each affiliate. (Ex. A-3 at 4.) Thus, each transaction will be recorded on Cooperative's books as
25 a credit to the appropriate general ledger account for the amount of Cooperative's investment in each
26 affiliate and a debit to a general ledger account for Cooperative's investment in VTG Holdings. (Ex.
27 A-3 at 4.) The amount debited for the investment in VTG Holdings will equal the sum of the net
28 book values of the investments in the affiliates. (Ex. A-3 at 4.) As a result, there will be no gain or

1 loss recognized by either VTG Holdings or Cooperative, and Cooperative's balance sheet and
2 financial condition will not have changed. (Ex. A-3 at 4.) If VTG Holdings ever dissolves,
3 liquidates, or disposes of one of the affiliates, Cooperative will indirectly recognize any associated
4 gain or loss through the equity method of accounting for recording income and loss from investments
5 in the affiliates. (Ex. A-3 at 4.) This would be the case whether Cooperative owned the affiliates
6 directly, as at present, or indirectly through VTG Holdings, as proposed. (Ex. A-3 at 4.)

7 23. As of December 31, 2007, the consolidated value of the stock⁵ in the affiliates, which
8 is equal to the net book value of that stock, was \$25,194,265. (Tr. at 74.) The value breaks down to
9 approximately \$12.3 million for VTC, approximately \$7.9 million for Copper Valley, and
10 approximately \$5 million for Valley Connections. (Tr. at 75.) These values represent the actual
11 equity of each affiliate shown on their balance sheets. (Tr. at 82.) Had the reorganization been
12 approved as of December 31, 2007, the transfer would essentially have been shown on Cooperative's
13 books as a \$25 million investment in VTG Holdings. (Tr. at 75.) The transaction is basically a
14 transfer on Cooperative's books to a new investment account, with no change in the overall total
15 assets. (*Id.*) There will be no change in the value of the stock when held by VTG Holdings as
16 opposed to Cooperative. (*Id.* at 75-76.) VTG Holdings' books will show, approximately, a \$12.3
17 million investment in VTC, a \$7.9 million investment in Copper Valley, and a \$5 million investment
18 in Valley Connections. (*See* Tr. at 83.) The affiliates will not actually be transferring any stock; they
19 will be canceling the stock that has been issued to Cooperative and reissuing stock in the name of
20 VTG Holdings. (Tr. at 84.) The values of the affiliates will not be affected at all. (Tr. at 85.)

21 24. Staff believes that the reorganization will add no value to, and will remove no value
22 from, the affiliates, as it is a rearrangement of the entities under a new organization with no change in
23 value. (Ex. S-2 at 10.) Mr. Carlson testified that VTG Holdings' only value will be the ownership of
24 the shares of the affiliates and that those shares will not change in value when essentially transferred
25 by Cooperative. (*See id.*) Furthermore, Mr. Carlson pointed out that, after reorganization,
26 Cooperative will still own all of the affiliates through its ownership of all the shares of VTG

27
28 ⁵ Because Valley Connections is a limited liability company, "stock" is used here to include membership interest.

1 Holdings. (*Id.*)

2 FOF 24—Allocation of Tax Liabilities & Credits; Commission Approval

3 25. Findings of Fact No. 24 in Decision No. 70307 stated that the affiliates would allocate
4 income tax liabilities or credits based on their respective contributions of net income or net loss to the
5 consolidated net income or net loss shown on the consolidated income tax return, but that the record
6 in this matter was silent regarding whether this allocation of tax liabilities or credits among the
7 affiliates would require Commission approval.

8 26. Cooperative and the affiliates believe that prior Commission approval is not required
9 before a reimbursement can be made by one affiliate to another affiliate for the amount of the tax
10 benefit derived by the use of the first affiliate's net operating loss, as A.A.C. R14-2-804(B) does not
11 require prior Commission approval for such a transaction. (Ex. A-3 at 10; Tr. at 45, 57.)

12 27. A.A.C. R14-2-804(B) states:

- 13 B. A utility will not consummate the following transactions without
14 prior approval by the Commission:
- 15 1. Obtain a financial interest in any affiliate not regulated by
the Commission, or guarantee, or assume the liabilities of
16 such affiliate;
 - 17 2. Lend to any affiliate not regulated by the Commission, with
the exception of short-term loans for a period less than 12
18 months in an amount less than \$100,000; or
 3. Use utility funds to form a subsidiary or divest itself of any
established subsidiary.

19 28. In his testimony, Mr. Miller explained that the affiliated interest rules of the Federal
20 Communications Commission ("FCC"), codified in Part 32 of the Uniform System of Accounts (47
21 Code of Federal Regulations ("C.F.R.") Part 32), require that the income tax expense or benefit
22 recorded by a regulated telephone company be calculated on a stand-alone basis. (Ex. A-3 at 9.)
23 Specifically, Mr. Miller cited 47 C.F.R. § 32.27(e), which states:

24 (e) Income taxes shall be allocated among the regulated activities
25 of the carrier, its nonregulated divisions, and members of an affiliated
26 group. Under circumstances in which income taxes are determined on a
27 consolidated basis by the carrier and other members of the affiliated
28 group, the income tax expense to be recorded by the carrier shall be the
same as would result if determined for the carrier separately for all time
periods, except that the tax effect of carry-back and carry-forward
operating losses, investment tax credits, or other tax credits generated by
operations of the carrier shall be recorded by the carrier during the period

in which applied in settlement of the taxes otherwise attributable to any member, or combination of members, of the affiliated group.

47 C.F.R. § 32.27(e) (emphasis added). Mr. Miller acknowledged that 47 C.F.R. Part 32 only applies to the regulated telephone companies, but stated that, as a practical matter, the entire Valley Telecom Group complies with 47 C.F.R. Part 32 to ensure compliance by the regulated telephone companies. (Tr. at 68.)

29. Mr. Miller testified that the income tax expense or benefit recorded for each regulated affiliate will represent the amount of income tax expense or benefit had the regulated affiliate filed a separate return. (Ex. A-3 at 9.) Mr. Miller further explained how the tax treatment will occur as follows:

The one with the income with or without the consolidated income tax return is going to pay tax on that income. Whatever the net taxable income is times the tax rate, Federal and State rate[,] that is what they would owe to the taxing authority.

Where the consolidated income tax return is important or beneficial to the group as a whole is that if the Company that is profitable is going to pay, let's say, combined Federal and State rate of 40 percent times their income, and you have another entity with a loss, you can consolidate the two[. Why not leave that 41 percent within the Company as opposed to the cash out to the Federal Government[?]

The way that gets accomplished is that you record an income tax expense on the taxable entity. You record a benefit on the income statement of the loss Company in that year, and you record a payable/receivable between the two Companies. Typically that payable/receivable for that tax [e]ffect is then satisfied at some point in time and cashed.

Now, it may not be a direct cash payment immediately like it would be [with] a Federal income tax deposit, but it is recorded as an intercompany transaction, and it is equal to the amount that would have been paid to the taxing authority, but for the consolidated . . . Federal income tax return.

(Tr. at 60-61.) Mr. Miller testified that the difference is not in the amount to be paid out by an affiliate, because each affiliate will pay out the same amount as it would if it were to file on a stand-alone basis, but in to whom the cash is paid. (Tr. at 65.) The amount due is paid to the affiliate that generated the loss, rather than to the taxing authority, initially through being recorded as an intercompany payable/receivable and ultimately as a cash payment. (*Id.*)

30. Mr. Miller provided a real-world example of how the consolidated tax return works when one affiliate has a net operating loss:

1 During the Cooperative's first period of operating as a taxable cooperative
2 from 1991 through 1996, the Cooperative and its Affiliates filed
3 consolidated federal and state income tax returns. For Copper Valley
4 Telephone's first and second years of existence—1995 and 1996—it
5 generated net operating losses of \$188,063 and \$1,044,246, respectively.
6 Since Copper Valley Telephone was included in a consolidated income tax
7 return, these net operating losses were used to reduce taxable income for
8 the consolidated group. Additionally, Copper Valley Telephone was
9 reimbursed for the use of the net operating losses by other members of the
10 consolidated group at a combined federal and state income tax rate of
11 approximately 41.6%.

12 (Ex. A-3 at 11.) Mr. Miller pointed out that this situation actually resulted in VTC, a non-regulated
13 entity, paying Copper Valley, a regulated entity, for use of its tax loss. (Tr. at 61-62.)

14 31. Mr. Miller also testified that, with a consolidated tax return, it is not possible for an
15 affiliate not to reimburse for the use of the tax loss—it must either go to the government or be
16 consolidated in the tax return and accrue to the benefit of the affiliate with the loss. (Tr. at 85.) Only
17 the timing of when the intercompany payable/receivable gets satisfied is within the control of the
18 affiliates. (Tr. at 86.)

19 32. Staff does not believe that any of the fund transfers that would occur as a result of the
20 consolidated tax returns would need to be approved separately or reported to the Commission under
21 the Affiliated Interest Rules (A.A.C. R14-2-801 et seq.), as the transfers of funds would not represent
22 loans or equity infusions. (Tr. at 103-04.) Mr. Carlson testified that the only transfer of funds
23 resulting from the consolidated income tax returns would be to rebate for use of tax credits, which is
24 simply an operational transfer of funds to equalize the accounts between two affiliates under the same
25 parent. (Tr. at 104.) Even if VTC, a non-regulated entity, is the affiliate that has an operating loss
26 and receives funds from regulated affiliates to reimburse it for the use of that loss, Staff does not
27 believe that there is a problem under the Affiliated Interest Rules because the regulated entities still
28 must calculate their income taxes on a stand-alone basis, and their tax obligations do not change, they
just are paid in part to the non-regulated affiliate with the operating loss to reimburse it for the use of
its tax credit. (Tr. at 104-05.)

33. Staff does not believe that Cooperative and the affiliates need to obtain a waiver of the
Affiliated Interest Rules to enable the filing of consolidated tax returns with VTG Holdings and the
fund transfers that are expected to occur as a result. (See Tr. at 96-97.)

1 Transfer of Ownership Interest in Valley Connections from Copper Valley to Cooperative

2 34. Prior to September 30, 2006, Valley Connections was owned by Cooperative and
3 Copper Valley. On September 30, 2006, Copper Valley transferred its membership interest in Valley
4 Connections to Cooperative, resulting in Cooperative's becoming the direct owner of 100 percent of
5 Valley Connections, as opposed to the direct owner of approximately 50 percent and the indirect
6 owner (through Copper Valley) of the other approximately 50 percent. (Tr. at 18.) Cooperative and
7 Copper Valley did not seek Commission approval of this transaction because there was no change in
8 control, and Cooperative and Copper Valley believed that no approval was required. (*Id.*)

9 35. When Copper Valley transferred its interest in Valley Connections to Cooperative in
10 September 2006, Copper Valley received from Cooperative \$755,098 in cash, which was the net
11 book value⁶ of Copper Valley's investment in Valley Connections as of that date. Mr. Miller testified
12 that the financial condition of Copper Valley and Cooperative was not impaired by the transfer and
13 that the net effect on their respective balance sheets was zero because the transfer was made at net
14 book value. (Tr. at 53.)

15 36. Staff agrees that the transfer of the ownership interest in Valley Connections from
16 Copper Valley to Cooperative resulted in no valuation change and no gain or loss recorded for
17 financial statement purposes, because it was made at net book value. (Ex. S-2 at 11.) Staff does not
18 believe that the net share valuations of Cooperative or any of the affiliates were changed as a result of
19 this transfer. (*Id.*) Copper Valley did, however, realize a gain of \$151,391 on the transfer for
20 purposes of income tax reporting.⁷ Copper Valley's gain was initially deferred in 2006 and will be
21 partially recognized in subsequent tax years. (*Id.*)

22 37. Staff did not consider, as a separate issue in this matter, whether the transfer of Copper
23 Valley's interest in Valley Connections to Cooperative required prior Commission approval. (Tr. at
24 96.) However, Mr. Carlson testified that he believes the transfer needed to be approved by the

25 ⁶ Mr. Metts explained in his testimony that "net book value" means "the original investment of Copper Valley in Valley
26 Connections less proportionate losses accumulated through the date of the transfer of Copper Valley's membership
interest." (Ex. A-2 at 5.)

27 ⁷ The sale proceeds were \$755,099, which is the same as the net book value of the ownership interest as of September
28 30, 2006. (Ex. S-2 at ex. A.) Because the net book value was the same as the sale price, Copper Valley's financial
statement shows no gain or loss. (*Id.*) The tax basis of the ownership interest was \$603,708, resulting in the \$151,391
gain for tax purposes. (*Id.*)

1 Commission under the Affiliated Interest Rules. (Tr. at 103.)

2 38. A.R.S. § 40-285(D) and (E) provide:

3 D. A public service corporation shall not purchase, acquire, take or
4 hold any part of the capital stock of any other public service corporation
organized or existing under the laws of this state without a permit from the
5 commission.

6 E. Every assignment, transfer, contract, or agreement for assignment
or transfer of any stock in violation of the provisions of this section is
7 void, and the transfer shall not be made on the books of any public service
corporation.

8 39. When it purchased Copper Valley's interest in Valley Connections, a CLEC,
9 Cooperative essentially purchased part of the capital stock of another public service corporation.
10 Indeed, Cooperative and the affiliates themselves, in the application, referred to this transaction as a
11 transfer of "stock." (See Ex. A-1 at 2.) We believe that this transaction required prior Commission
12 approval under A.R.S. § 40-285(D) and that, under A.R.S. § 40-285(E), the transaction is void
13 without it. We also believe, however, that this transaction is in the public interest and should be
14 approved.

15 Compliance with Prohibition on Providing Funding to Valley Connections

16 40. Mr. Metts testified that the transfer of Copper Valley's interest in Valley Connections
17 was made in part because the Commission, in Decision No. 68080 (August 17, 2005), prohibited
18 Cooperative and Copper Valley from providing additional funding to Valley Connections except
19 from deregulated operations. (Tr. at 28.) Copper Valley had no deregulated operations or subsidiary
20 to provide funding to Valley Connections, so Copper Valley was restricted from providing additional
21 equity. (*Id.*) As a result, Copper Valley was unable to maintain a 50-percent interest in Valley
22 Connections due to Cooperative's equity infusions and Copper Valley's own inability to infuse
23 equity. (Tr. at 28-29, 41-43.) Because Cooperative owns VTC, which has deregulated operations,
24 VTC was able to give a dividend to Cooperative, thereby enabling Cooperative to infuse funds into
25 Valley Connections to sustain it, (Tr. at 29), as Decision No. 68080 expressly provided that
26 distributions to Cooperative from VTC could be used to provide further funding to Valley
27 Connections, (Decision No. 68080 at 3). The only funding of Valley Connections that has occurred
28 is through funds provided to Cooperative by VTC. (Tr. at 32.)

1 41. Staff does not believe that any of the transfers of funds that would occur in the context
2 of the consolidated tax returns would be a violation of Decision No. 68080's prohibition on providing
3 further funding to Valley Connections. (Tr. at 97-98.) Mr. Carlson testified that he believes the
4 prohibition in Decision No. 68080 was directed to equity infusions, not the type of transaction
5 contemplated here where funds will be moved to offset tax liabilities. (Tr. at 107-08.) Mr. Miller
6 testified that, if it were Valley Connections that has a loss and thus receives payment from a regulated
7 affiliate with taxable income because of a consolidated income tax return, Valley Connections is not
8 actually receiving an infusion of equity; rather, Valley Connections is being paid for something that it
9 is providing—the use of its loss for tax purposes. (Tr. at 80-81.)

10 42. We concur with Staff that the transfers of funds that would occur in the context of the
11 consolidated tax returns would not be a violation of Decision No. 68080's prohibition on providing
12 further funding to Valley Connections.

13 Conclusion

14 43. The Affiliated Interest Rules apply to all Class A investor-owned utilities, defined as
15 telecommunications carriers that have Arizona jurisdictional annual revenue of more than \$1 million.
16 According to its 2006 Annual Report filed with the Commission, Cooperative generated more than \$1
17 million in annual Arizona jurisdictional revenue.

18 44. Under A.A.C. R14-2-803(C), it is appropriate to approve the application in this matter
19 if the organization of VTG Holdings (1) will not impair Cooperative's financial status; (2) will not
20 otherwise prevent Cooperative from attracting capital at fair and reasonable terms; and (3) will not
21 impair Cooperative's ability to provide safe, reasonable, and adequate service.

22 45. Staff believes that the proposed reorganization is in the public interest and
23 recommends approval of the application. (Ex. S-2 at 14; Tr. at 94.) Staff further recommends
24 approval of Staff's original Recommended Order from October 2007.⁸ (Ex. S-2 at 14.)

25 46. Staff's recommendation to approve the application is reasonable and should be
26 followed. There is no evidence to suggest that the organization of VTG Holdings as a public utility
27

28 ⁸ In light of the additional evidence obtained through the hearing, which was not reflected in the original Recommended Order, preparation of a Recommended Opinion and Order was required.

1 holding company, as proposed in the application, will impair Cooperative's financial status; will
2 prevent Cooperative from attracting capital at fair and reasonable terms; or will impair Cooperative's
3 ability to provide safe, reasonable, and adequate service. Furthermore, there is no evidence to suggest
4 that the organization of VTG Holdings will have any adverse impact on the affiliates.

5 **CONCLUSIONS OF LAW**

6 1. Cooperative, Copper Valley, and Valley Connections are public service corporations
7 within the meaning of Article XV of the Arizona Constitution.

8 2. VTC is an affiliate of Cooperative under A.A.C. R14-2-801(1).⁹

9 3. The Commission has jurisdiction over Cooperative, Copper Valley, and Valley
10 Connections and over the subject matter of the application.

11 4. Notice of the application was given in accordance with the law.

12 5. Pursuant to Article XV of the Arizona Constitution and the Arizona Revised Statutes,
13 the organization of VTG Holdings as a public utility holding company, as proposed in the
14 application, is in the public interest and meets the standard for approval under A.A.C. R14-2-803(C).

15 6. The 2006 transfer of Copper Valley's interest in Valley Connections to Cooperative
16 required Commission approval under A.R.S. § 40-285(D) and is void without it, under A.R.S. § 40-
17 285(E).

18 7. Pursuant to Article XV of the Arizona Constitution and the Arizona Revised Statutes,
19 the 2006 transfer of Copper Valley's interest in Valley Connections to Cooperative is in the public
20 interest and should be approved.

21 8. The filing of a consolidated income tax return by VTG Holdings and the affiliates,
22 with or without Cooperative, is not a transaction for which prior Commission approval is required
23 under A.A.C. R14-2-804(B).

24 9. The fund transfers that may occur as a result of consolidated tax returns filed by VTG
25 Holdings and the affiliates, with or without Cooperative, to reimburse an affiliate with an annual loss
26 for the use of that loss to offset another affiliate's annual income, are not transactions for which prior
27

28 ⁹ Without additional information about VTC's current operations, it is not possible to determine definitively whether VTC is currently a public service corporation within the meaning of the Arizona Constitution.

Commission approval is required under A.A.C. R14-2-804(B).

10. The fund transfers that may occur as a result of consolidated tax returns filed by VTG Holdings and the affiliates, with or without Cooperative, to reimburse an affiliate with an annual loss for the use of that loss to offset another affiliate's annual income, are not a violation of Decision No. 68080's prohibition on providing further funding to Valley Connections.

ORDER

IT IS THEREFORE ORDERED that the 2006 transfer of Copper Valley Telephone, Inc.'s membership interest in Valley Connections, LLC, to Valley Telephone Cooperative, Inc., is hereby approved.

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IT IS FURTHER ORDERED that the organization of VTG Holdings, Inc., as a public utility holding company, as described in the application and in Findings of Fact No. 2 herein, is hereby approved.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN

COMMISSIONER

COMMISSIONER

COMMISSIONER

COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Director of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this ____ day of _____, 2008.

BRIAN C. McNEIL
EXECUTIVE DIRECTOR

DISSENT

DISSENT

SNH:db

SERVICE LIST FOR:

VALLEY TELEPHONE COOPERATIVE, INC.;
COPPER VALLEY TELEPHONE, INC., VALLEY
CONNECTIONS, LLC and VALLEY
TELECOMMUNICATIONS COMPANY, INC.

DOCKET NOS.:

T-01847A-07-0392; T-02727A-07-0392; T-04169A-07-
0392 and T-02739A-07-0392

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